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IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1961.

No. 87.

MANAGED FUNDS, INCORPORATED,
Petitioner,

vs.

J. JOHN BROUK et al.,
Respondents.

BRIEF OF PETITIONER.

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MANAGED FUNDS, INCORPORATED,
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vs.

J. JOHN BROUK et al.,
Respondents.

BRIEF OF PETITIONER.

Writ of Certiorari was granted in this case to review the judgment of the United States Court of Appeals for the Eighth Circuit, which reversed orders of the District Court overruling motions of certain defendants to dismiss the complaint.

OPINIONS BELOW.

The District Court did not file an opinion. The opinion of the Court of Appeals is reported at 286 F. 2d 901.

JURISDICTION.

The judgment of the Court of Appeals (R. 72) was entered on January 13, 1961. On February 1, 1961 petitioner filed a petition for rehearing in the Court of Appeals, and on February 6, 1961, a motion of the Securities and Exchange Commission for leave to participate amicus curiae was filed. Petitioner's motion for rehearing and the motion of the Securities and Exchange Commission were denied on March 6, 1961.

Petitioner filed its Petition for Writ of Certiorari with this Court on the 6th day of May, 1961. Thereafter, the Securities and Exchange Commission filed its brief as amicus curiae in support of the Petition for Writ of Certiorari.

On the 19th day of June, 1961, this Court granted certiorari.

The jurisdiction of this Court rests on 28 U. S. C., Section 1254 (1).

STATUTE AND RULE INVOLVED.

The statute involved is the Investment Company Act of 1940 (Section 80a of Title 15, U. S. C.*), regulating the internal affairs and the investment advisory contracts of mutual funds. Section 1 (b) (2) declares that the evils at which the Act is directed include "inside" operation by directors who are self-interested advisers, or by salesmen or brokers having conflicts of interest, and that the Act is to prevent operation of such funds for the profit of

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* The section numbers of 80a correspond to the section numbers of the Act, until 80a-29, which is Section 30 of the Act, and from there on the corresponding section numbers of the Act are one digit above the section numbers set forth in 80a

such insiders, rather than for the investors; this purpose is a guide [1 (b)] in interpreting the Act, so as to mitigate or eliminate the evils enumerated. Sections 9 and 10 regulate the composition of boards of directors so as to limit the number of self-interested ("affiliated") advisers and brokers or underwriters who may serve on such boards.

Particularly relevant to this case are the following Sections of the Act: Section 15 requiring initial approval by shareholders of self-dealing contracts of advisers and underwriters and the extension thereof either by shareholders or by disinterested ("unaffiliated") directors; Violation of Section 15 makes such contracts illegal; Section 8 (b) (2), requiring the management to declare the fund's fundamental investment policies for information of investors; and Section 13 (a) (3), making deviation from such declared policies, without stockholder approval, illegal.

There is also an important substantive or remedial provision of the Act involved here: Section 47 (b) [Section 80a-46 (b) of Title 15, U. S. C.] which declares that contracts made in violation of the statutory provisions are "void", not merely voidable as in the case of "insiders" contracts at common law.

And there is the specific jurisdictional section of this Act, Section 44 (Section 80a-43 of Title 15, U. S. C.) further aiding in the enforcement of said provisions, which gives concurrent jurisdiction to State and Federal courts "of all suits in equity and actions at law brought to enforce any liability or duty created by the Act," and provides for long arm service of process for actions brought in the Federal Court.

Rule 8 (a) of the Federal Rules of Civil Procedure, which provides that plaintiff need only plead a short,

plain statement of facts setting forth its claim, is involved in the construction of the complaints.

These sections of the Act and the said rule are set forth in full in the Appendix.

QUESTIONS PRESENTED FOR REVIEW.

1. The first question presented is whether the Investment Company Act of 1940 imposes duties on the directors of a mutual fund registered thereunder, and if so, whether the breach of such duties, including their own participation in illegal action, gives rise to a civil cause of action, under Section 44 of the Act, by such a mutual fund against the directors in the District Court of the United States.

2. The second question is whether the complaints, which aver that these respondent directors knowingly participated in violations of the Act and breached their own statutory duties created by the Act, state a claim within the broad liberality afforded a pleader under Rule 8 (a) of the Federal Rules of Civil Procedure.

STATEMENT OF THE CASE.

Petitioner is a mutual fund registered as an investment company under the said Investment Company Act of 1940. Suits were brought by the Petitioner and by a stockholder on behalf of Petitioner against its former investment advisers, sales companies (underwriters), directors, and brokers in the United States District Court, for alleged violations of and breaches of duty created by the Investment Company Act of 1940. Jurisdiction was based on Section 44 of the Act.

Both suits were filed after public disclosures in "Stop-order Proceedings" before the Securities and Exchange Commission, in May of 1959.*

The first suit was a derivative stockholder's suit instituted in the United States District Court in Delaware by Emanuel Josephson on behalf of Managed Funds (R. 12). The second suit was instituted by Managed Funds itself in the United States District Court for the Eastern District of Missouri (R. 1). The Josephson case was thereafter transferred to the said District Court in Missouri (R. 13) and the causes consolidated (R. 28).

The complaints sought to recover (1) unearned advisory fees in excess of $1,000,000 paid to the Fund's disclosed adviser, (2) brokerage commissions in excess of $1,500,000 paid to the Fund's undisclosed and unapproved adviser (a brokerage firm which took over the official adviser's func-

* The Securities and Exchange Commission, on July 31, 1959, entered an order prohibiting Managed Funds from selling its stock. *In Re Managed Funds*, C. C. H. Fed. Sec. Law Rep., Current, Par. 76,662 (1959), for the reason, inter alia, that the Fund was operating with an unlawful investment adviser. The S. E. C. made this finding regarding respondent directors (p. 80,509):

> "On the basis of the record it is evident that the directors failed to discharge their duties and responsibilities as directors, and failed to perform the functions which the prospectus represented they were performing."

tions) for investment advice illegally rendered, and for brokerage transactions which were also illegal under Section 13 (a) (3) because they were contrary to the Fund's stated and fundamental investment policy, and (3) the Fund's damage in making said payments and for losses resulting from excessive brokerage transactions. The accountability for the said monies paid and the damages incurred were based upon alleged violations by defendants including respondent directors of the Investment Company Act of 1940, and for breaches of statutory duty imposed thereby.*

As above mentioned, jurisdiction was based on Section 44 of the Investment Company Act of 1940 (80a-43 of Title 15, U. S. C.) which provides that the "district courts . . . shall have jurisdiction of violations" of the Act, and of "all suits in equity and actions at law brought to enforce any liability or duty created by, or enjoin any violations of" the Act.

Respondents, who were certain of the defendant directors, moved to dismiss the action on the ground that there was no jurisdiction over the subject matter** for the reason that there were no duties of directors created by

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* The Managed Funds complaint contains three other counts: Count II (R. 8) asserts liability for losses under the Securities Act of 1933; Count III (R. 9) bases liability for breaches of fiduciary duties; and Count IV (R. 11) seeks recovery on the claim of a conspiracy. Count III reasserts jurisdiction under the Investment Company Act, but adds that "the unlawful and wrongful acts" constituted breaches of fiduciary duty at common law. Standing alone even without reference to the statute such counts may be joined with Petitioner's statutory claim. *Hurn v. Oursler*, 289 U. S. 238, 77 L. Ed. 1148, 53 S. Ct. 586 (1933).

** Certain of the respondents, who were non-residents, also asserted that there was no jurisdiction over their respective persons, since they were served with process by extra-territorial service as authorized by Section 44 of the Investment Company Act of 1940. The District Court also ruled against respondents on this phase of the motion. The Court of Appeals did not pass on this issue.

the Investment Company Act of 1940, and hence no remedy against them cognizable in the Federal District Court.

District Judge Randolph H. Weber overruled respondents' motions to dismiss the complaints (R. 28). After the Court of Appeals for the Eighth Circuit permitted respondents to appeal this interlocutory order under the new interlocutory appeal (Section 1292 (b), Title 28, U. S. C. (R. 39)), it reversed Judge Weber's rulings (R. 72) on the grounds that there were no statutory duties of directors under the Investment Company Act of 1940 nor any legislative intent in enacting said statute to impose statutory duties upon directors (R. 58-60), no remedy for breach (R. 60), and that the complaints, which alleged a knowing participation by directors in violations of the Act (R. 6, 19) only asserted "insurers" liability (R. 71).

Subject Matter and Terminology of the Act.

A brief description of the subject matter of this legislation seems to be desirable at this point, so that the issues presented herein are more easily understood.

The Investment Company Act of 1940 does not authorize or purport to create mutual funds, but rather, it is a regulatory statute imposing certain restrictions on the operation of mutual funds, as this investment business had developed by 1940—already a multi-billion dollar "industry." Mutual funds were commonly organized under state law in a corporate form (less frequently, in trust form) and were usually "organized" or "sponsored" by investment or brokerage houses (Jaretzki, "The Investment Company Act of 1940," Wash. U. L. Q. [April, 1941*]). The appeal of a fund—especially to small in-

* Mr. Jaretzki represented a group of closed-end investment companies at the Senate and House hearings on the investment company bill, and participated in certain negotiations which led to an agreement in regard to the drafting of the bill. The article cited above contains a very comprehenhive discussion of the evils

vestors (Id. at 308), was the fact that the shares of the fund were offered to the public as a device whereby a small investor could conveniently participate in diversified investments in corporate stocks (Id. at 305).

Relevant to the sections of the Act here relied upon, is the reason or incentive which led to the organization and creation of mutual funds—that is, the compensation or "profit incentive." The organizer of a fund would usually also own or control the corporate "investment advisor" to the fund—this advisor would receive as compensation for its services, a fixed percentage of the value of the portfolio. Also, it was not uncommon for the "organizer" to own or control the corporate "underwriters" which sold the shares of the fund to the public, so that there was also compensation to the "organizer" by way of sales commissions on these sales. Of course, there were also the brokerage commissions to be realized on the sales and purchases of the portfolio securities held by the mutual fund—another valuable item of patronage.

Since it was important to the organizers that these advisory fees, sales commissions, and brokerage fees be awarded by contract or practice to themselves, they were commonly represented in the counsels of the management of the fund (the Investment Company Act refers to them as "affiliated persons"). Thus, as these funds developed, there were contractual relationships involved in the basic operation of the fund which were fraught with self-interest and dealings by "insiders" (or affiliated persons). Abuses arising out of this conflict of interests and interlocking relationships (together with other problems) in 1940 led to the adoption of the Investment Company Act.

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in the mutual fund industry which gave rise to the passage of the Investment Company Act, plus an informative discussion of the Act itself and what it was designed to accomplish. Mr. Alfred Jaretzki was a partner in the law firm of Sullivan and Cromwell in New York. He fully documents his article by reference to Congressional Reports and proceedings.

The Complaints.

The facts set forth in the Complaints are confessed by respondents' motion.

1. **The Parties Defendant.** The following is a list of the defendants:

Individual Slaytons (Hilton & Hovey)	Officers and directors in "working control" of the Fund (R. 14) who also controlled or owned the Slayton Companies (R. 2).
Slayton Companies*	
Slayton & Co., Inc., and Mutual Funds Distributors, Inc.	"Underwriters" which sold the Fund's shares to the public, controlled by the Slaytons.
Slayton Associates, Inc.	The Fund's designated investment adviser, owned by the Slaytons.
Directors (including Respondents)	Twelve former directors, other than the Slaytons, referred to in Fund's complaint as "outside directors" (R. 3).
Model, Roland & Stone	A partnership of eleven New York brokers (R. 3).
Stephen M. Jacquith	Associated with the brokers as investment adviser (R. 14).
Harold W. Smith	Brother-in-law of defendant Hovey Slayton and "employee" of brokers (R. 3).
James S. Stubbs	Former director of Fund, former business associate of the Slaytons and "employee" of brokers (R. 3).

* Slayton Associates, Inc., is hereinafter referred to as "Slayton Associates"; Slayton & Company, Inc. and Mutual Fund Distributors, Inc., are hereinafter referred to, separately as "Slayton & Co." and "Mutual", and jointly as "Slayton Sales Companies."

2. **Resumé of Facts Alleged in the Complaints.**

While the details of the complaints are summarized and analyzed below, it can be stated that the following averments of illegality are common to both complaints:

(a) That the petitioner Managed Funds was operated, by the respondent directors, under an illegal investment advisory contract arranged by the Slaytons, who dominated the operation, with the defendants Jaquith and his employer Model, Roland & Stone (the defendant New York brokerage firm) and that this contract was illegal under Section 15 (a) of the Act because it had never been approved by shareholders as required by that Section (R. 5, 7);

(b) That the official investment advisory contract made by the Fund with the defendants Slayton Associates, Inc., was terminated by abdication of the Slaytons and assignment thereof, which assignment terminated this contract, according to its terms, and as required by the Act; but that nevertheless said employment was continued by "successive written contracts" (R. 15) from year to year, under the management of the directors, in violation of Section 15 (c) of the Act, charging them with responsibility for renewals of such employment.

(c) That after the Fund had declared an official policy of "capital growth," its portfolio was mismanaged by defendants, causing a "deviation" from declared policy made illegal by Section 13 (a) (3), of the Act (R. 4, par. 12; R. 7, par. (c)).

A. **The Fund's unlawful investment advisers and the parties responsible for payments made to said advisers.**

Commencing August 15, 1952, and continuing until April, 1959, the Slaytons' advisory corporation, Slayton

Associates, was awarded successive written contracts to act as the Fund's disclosed investment adviser (R. 4, 15).

This initial advisory contract was approved by the Fund's stockholders as required by Section 15 (a) of the Act, but relevant to the averments in the complaints, this written contract was, after August 15, 1954, extended each year throughout the period (R. 15). Under Section 15 (c) of the Act such contract could only be extended by stockholders or a majority of the "unaffiliated directors." The respondents, as above stated, are all unaffiliated directors designated as "outside directors" in the petitioner's complaint (R. 3).

This advisory contract provided that Slayton Associates would render advisory, research and statistical services with reference to investments as were in accordance with Managed Funds' policies (R. 4). Slayton Associates was paid by the Fund an annual fee in the amount of ½ of 1% of the Fund's asset value (R. 4), and said payments over the period totaled in excess of $1,000,000 (R. 15). This August 15, 1952, contract, effective throughout the period, provided that it was not assignable (R. 15); such a provision was required by the Act, Section 15 (a) (4).

Commencing on December 1, 1953, and continuing until April, 1959, defendant Jaquith (the defendant brokers' investment adviser) assumed the duties of Slayton Associates, the above-mentioned designated investment adviser for Managed Funds (R. 5, 15). Slayton Associates, while still receiving the fee from the Fund as set forth above, for purporting to perform advisory services, unlawfully delegated its duties to Jaquith and the defendant brokers and abdicated its duties and responsibilities under said contract (R. 5). This assignment terminated the contract and rendered the payments illegal.

This assignment and transfer to defendant Jaquith of the advisory functions took the form of a ten-year con-

tract, dated December 1, 1953, wherein defendant Jaquith was employed as investment counsellor and manager of the securities portfolio of the Fund (R. 5) and was to use his best judgment in the selection, purchase and sale of securities for the Fund and was to be compensated in the form of minimum brokerage commissions with respect to the Fund's portfolio transactions directed to Jaquith's firm, the defendant brokers (R. 5, 15).

Neither the said contract of December 1, 1953, between Slayton Associates and Jaquith, nor Jaquith's assumption of the investment advisory function for Slayton Associates thereafter, was ever approved by the stockholders of Managed Funds (R. 7, 16), as required by Section 15 of the Act.

Notwithstanding the assignment by Slayton Associates and the assumption of the advisory function by the defendant brokers and the failure to have this relationship approved by the stockholders, the Slaytons and the directors, including the respondents, caused or permitted (R. 6, 19) the Fund to continue the Slayton Associates contract for five and one-half years and to pay Slayton Associates in excess of $1,000,000 during the period for services that Slayton Associates did not perform (R. 16).

It followed from the termination, by assignment, of the Slayton Associates contract, that Jaquith and the partnership of Model, Roland and Stone "served or acted as investment advisers of the plaintiff without a written contract approved by a vote of majority of the outstanding voting securities of plaintiff" [R. 7, par. 21 (d)].

During this same period, the same defendants caused the Fund to pay the defendant brokers and Jaquith in excess of $1,500,000 in brokerage commissions in payment for investment advice (R. 5, 16).

The complaints allege that such conduct was in violation of the Investment Company Act of 1940 since Slay-

ton Associates unlawfully abdicated its function and defendants Jaquith and the brokers served and acted as investment advisers, without a written contract approved by the stockholders (R. 7). Section 15 (a) provides that it is illegal to act as an investment adviser unless a written contract is approved by the stockholders of the fund. Subsection 15 (a) (4) requires automatic termination of a stockholder-approved advisory contract upon its assignment. Aiding the remedy, both illegal contracts were expressly declared "void" under Section 47 (b), Title 15, U. S. C., Sec. 80a-46 (b).

Managed Funds claimed it was a breach of the directors' duties under the Act [15 (c)] to approve an advisory contract, and make payments thereunder when the designated adviser was rendering no services therefor and when the contract, by the provisions of the Act, had been terminated [15 (a) (4)] and was void [47 (b)]. It was a further breach of the directors' duties, under 15 (a) and (c), to cause Managed Funds to operate, and to pay out money to the defendant brokers, under the unapproved and second illegal and void contract! Not only was it alleged that respondents did this, but it is alleged that they did it "knowingly" (R. 6, 19).

B. **The Fund's unlawful deviation from its stated investment policy and parties responsible therefor.** Part and parcel with the payments made under said unlawful advisory contract were the directors' breach of duty in following an unlawful investment policy, or as the Act calls it, "deviation" from the declared policy—required to be disclosed.

In accordance with the Investment Company Act Section 8 (b) (2), the announced policy of Managed Funds, as set forth in its registration statements and prospectuses, was to provide for "capital growth" and to the extent consistent with such policy, to seek reasonable income on

its investments, which net investment income and any realized profits on the sale of securities in its portfolio would be distributed quarterly (R. 4).

After the defendant Jaquith and the broker defendants usurped the advisory function, the Fund's basic policy of "capital growth" was not followed (R. 5, 6). Rather, a policy was followed in handling the Fund's portfolio so as to maintain a predetermined amount of distributions and, if income from portfolio investment was insufficient, to realize forced capital gains from the sale of the Fund's portfolio securities to pay these distributions (R. 5, 6).

This policy, which respondents followed at the direction of the insiders (R. 6, 19), was a deviation from the stated policy of "capital growth" in that the Fund's portfolio securities were "churned" so that in 1958, as an instance, the rate of turnover of the portfolio securities was 98% as compared with 20% average for mutual funds (R. 16).* This deviation from stated policy was likewise done without stockholder approval (R. 16).

The policy which was followed resulted in gross mismanagement of and loss and damage to the Fund's portfolio (R. 6). The portfolio was thus churned (R. 16) to realize capital gains so as to keep up an appearance of high "dividends", a sales feature exploited by the Slayton Sales Companies, who profited by touting this high return feature of the shares (R. 6).

Section 13 (a) (3) makes it unlawful to deviate from a mutual fund's fundamental policy, stated under 8 (b)

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* The S. E. C. in the Managed Funds, stop order proceedings particularized certain of these transactions, and concluded:

> "Registrant's transactions of the type illustrated by the foregoing table obviously served no legitimate purpose and were inconsistent with its stated policy of placing primary emphasis on capital growth." *In re Managed Funds, Inc.*, C. C. H. Federal Security Law Reporter, Current, Par. 76,662, p. 80,510.

(2), unless authorized by a majority of the fund's outstanding securities. The Managed Fund's complaint alleged that the policy followed was thus illegal as being contrary to the Fund's stated policy (R. 7). Further, it was alleged and it is contrary to the policy of the Act, Section 1 (b) (2), for a fund to be operated, managed, and its portfolio securities selected, in the interest of directors, officers, investment advisers, brokers and dealers, rather than in the interest of all classes of security holders (R. 6, 7).

The policy of high turnover of the Fund's portfolio securities resulted in a direct benefit to the defendant brokers and Jaquith (R. 6) who, as above stated, were also doubling as investment advisers and were being compensated in the form of brokerage commissions paid by the Fund on portfolio transactions (R. 5). The more the defendants bought and sold at the advice of these broker-advisers, the more commissions paid the broker-defendants. The $1,500,000 paid said brokers was sufficient to enable them to pay, at the direction of the Slayton defendants, the defendant Smith (Hovey Slayton's brother-in-law), and the defendant Stubbs (the Slaytons' former business associate and former director of the Fund) in excess of $50,000 per year each, in commissions, when said defendant recipients did not perform any services in return for such payments (R. 5).

Petitioner claimed respondent directors had a duty under the Act not to permit and certainly not to participate in causing a deviation from fundamental policy, and that they were jointly liable for this violation and breach of statutory duty; the directors are in charge of the Fund's investment policy; the capital gains which were realized pursuant to the policy actually followed were distributed to stockholders by these respondent directors, who declared dividends; the distribution of these capital gains by re-

spondents was part and parcel of the unlawful policy. These respondents knowingly participated, aided and abetted a plan whereby petitioner was operated in the interest of insiders rather than in the interest of the stockholders (R. 6, 19).

C. Participation and Knowledge of the Respondent "Outside" Directors.

The complaints in both cases charge "the defendants" (which, of course, includes the respondent directors) with violation of the Investment Company Act (R. 1 and R. 13).

The Managed Funds' complaint in Par. 6 (R. 3) refers to the defendant directors by name, including respondents, and calls them "outside directors"—a term now generally used to mean directors who are not officers of, or employed by, the company which they serve as directors. And in the context, the term would also mean "unaffiliated" directors as used in the Act. Here is the allegation as to the knowledge of these outside directors:

> "On information and belief, the said outside directors, and each of them, had either actual knowledge of the acts hereinafter complained of, or, in the performance of the duties and obligations imposed upon them by law as directors, and by the exercise of ordinary care and diligence in the performance of such duties and obligations, would have acquired knowledge of such acts, and hence are chargeable with having constructive knowledge thereof."

The same complaint states in Par. 21 that "the defendants" (including, of course, the respondents) "committed or with actual or constructive knowledge, as hereinbefore set forth, aided, abetted, acquiesced in, or condoned, directly or indirectly, violations of the Investment Company Act of 1940, in that, inter alia," (a) "the plaintiff was

operated, managed, and its portfolio securities were selected" in the interest of insiders; (b) the plaintiff Fund was caused to publish untrue statements; (c) the Fund was caused to deviate from a fundamental policy without authority of its "outstanding voting securities"; (d) the brokers and Jaquith "served or acted as investment advisers of the plaintiff, without a written contract, approved by a vote of majority of the outstanding voting securities of Plaintiff" (R. 6 and R. 7).

Count III of the Managed Funds' complaint re-alleges the basic facts of Count I: the illegal Jaquith contract; the abdication by Slayton Associates; the illegal deviation from declared policy. Then in substance, the Count sets up that the Slaytons and the broker—Model defendants were fiduciaries; the latter were acting as investment advisers (R. 9 and R. 10).

Then the knowledge of defendants is alleged: "and each of the other defendants had actual knowledge of the relationship of defendants Hilton H. Slayton and Hovey E. Slayton to plaintiff, and actual or constructive knowledge of the relationship of said members of the co-partnership of Model, Roland and Stone, and of Stephen M. Jaquith, to plaintiff" (R. 9 and R. 10).

Par. 6 of Count III says that "all of the defendants had actual knowledge of the fact of the relationship of defendants Hilton H. Slayton and Hovey E. Slayton to plaintiff; all of the defendants had actual or constructive knowledge of the relationship of the said defendants" (brokers and Jaquith) and "hence all defendants are chargeable with and liable for the said acts" (R. 10).

3. Relief Sought.

The complaints sought not only an accounting for profits from those defendants who profited, but also sought

damages from all defendants jointly liable, whose illegal acts proximately caused damage to the Fund. The damages claimed against respondents were for their participation in the unlawful payment of over $1,000,000 for "advisory services," which were not rendered, an obvious basis of damage. Secondly, respondents are alleged to be jointly liable for losses to Managed Funds as a result of the illegal investment policy followed. On the accounting aspect of the case (which overlaps the damage claims at least as to the fees paid the advisers), respondents are liable even if it is not alleged that they profited directly, since they knowingly made or permitted such payments to be made and should be jointly liable therefor.

Rulings on Respondents' Motions.

As above stated, Judge Weber overruled respondents' motions to dismiss. On the interlocutory appeal taken by respondents, the Court of Appeals reversed this ruling and ordered respondents dismissed from the cause. In its opinion the Court of Appeals held that there was no legislative intent to impose duties on directors (R. 60), and that the complaints which alleged knowing participation by these respondents asserted only insurers' liability (R. 71).

ARGUMENT.

The Court of Appeals erred in reversing the order of the District Court on the interlocutory appeal and in ordering respondent directors dismissed from the cause. There are duties imposed upon directors under the Investment Company Act and a mutual fund can recover its damages from them resulting from their violation or breach of duty. The complaints alleged a breach of certain statutory duties imposed on respondents and violation of the Act by respondents to the damage of the Fund. The Court of Appeals misconstrued the complaints as asserting insurers' liability, as the complaints alleged knowing participation in the illegal acts alleged and breach of duty by respondents.

SUMMARY OF THE ARGUMENT.

Specific sections of the Act impose duties upon directors, officers, investment advisers of a mutual fund, and Section 44 grants Federal jurisdiction if breach of these duties are alleged. The complaints allege a claim for breach of these duties and violation of the Act by respondents-directors to the damage of the Fund.

It is the intention of Congress to afford private remedies to suitors under the Securities Acts, cognizable in the Federal District Court. This is even more apparent under the Investment Company Act which regulates the internal affairs of mutual funds. Specific sections and the recited purpose and history of the Act strongly support the imposition of duties on directors and provide a private remedy to the Fund and shareholders who were intended to be protected.

The relevant sections of the Act here involved creating statutory duties on directors, are (1) Section 15, regulating the employment of insider, investment advisors and Section 47 (b), making illegal advisory contracts void, and (2) Sections 8 (b) (2) and 13 (a) (3), requiring adherence to stated, fundamental investment policy.

1. The directors under Section 15 are given the express responsibility to have investment advisory contracts approved by stockholders and by that section, it is illegal to perform an unapproved advisory contract. The directors have a duty of supervision under Section 15 and to use due diligence in extending stockholder approved contracts, and in operating the fund—authorizing the payment of money—under such contracts. Supplementing the remedy, Section 47 (b) makes illegal contracts void.

These duties were breached to the damage of the Fund when respondents knowingly approved and paid out monies

under one illegal advisory contract to an insider advisor (Slayton Associates), which was performing no services. The duties of these directors were further breached when, at the same time, the directors failed to submit to stockholders the employment of the actual adviser (the brokers), and knowingly permitted the Fund to operate with and pay money to such advisor (selected by the Slayton's to perform their advisory function) under this unapproved and, hence, illegal and void contract.

2. The directors have a duty, under 13 (a) (3), to require the fund to adhere to its stated fundamental investment policy. When they knowingly participate with insiders to cause the fund to deviate from that policy to the damage of the fund they are liable.

3. The complaints alleged a breach of these statutory duties by respondents to the damage of the Fund. It was alleged that the directors "knowingly" "participated" in specific violations of the Act. These allegations are sufficient to charge respondents themselves with such violations.

Under the rules, a pleader need only state a claim for relief and a complaint should not be dismissed unless it appears beyond doubt that plaintiff can prove no set of facts to support his claim.

Petitioner submits therefore that this Court should reverse the order of the Court of Appeals which dismissed respondents from the cause.

I.

The Investment Company Act of 1940 Imposes Duties on Directors and They Are Subject to Liability to the Mutual Fund for Which They Act, Where They Breach Such Duties or Participate in Violating the Act, Thereby Causing Damage to the Fund.

As above stated this action is grounded upon two primary breaches of duty created by the Act and respondents' participation in violating the Act.

It is necessary to trace the development of statutory liability as a basis for Federal jurisdiction and the cases under other Securities Acts where such questions have arisen in the past. We will then discuss the Investment Company Act and the particular sections here involved, to show that directors have duties under that Act and that respondents breached those duties to the damage of the fund.

The Basis of Statutory Liability Under the Securities Acts.

Other securities acts,* also have provisions giving the Federal Court jurisdiction over suits based upon a breach of statutory duties created by those acts. There have been numerous cases holding that a plaintiff may recover in tort for damages caused by the violation of duty created by one of these acts.**

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* Securities Act of 1933 and Trust Indenture Act of 1939 (Section 77 et seq. of Title 15, U. S. C.); Securities Exchange Act of 1934 (Section 78 et seq. of Title 15, U. S. C. A.); Public Utility Holding Company Act of 1935 (Section 79 et seq. of Title 15, U. S. C.).

** Cases in the Second Circuit: *Baird v. Franklin*, 141 F. 2d 238 (2d Cir., 1944), cert. denied, 323 U. S. 737, 89 L. Ed. 590, 65 S. Ct. 36; *Goldstein v. Groesbeck*, 142 F. 2d 422 (2d Cir., 1944), cert. denied, 323 U. S. 737, 89 L. Ed. 590, 65 S. Ct. 36.

This is the doctrine of implying a remedy for violation of a statute. Louis Loss, Securities Regulations, pp. 1043-1045 (1951), states the bases of such liability:

> "(a) The Bases of Liability.
>
> "The implied liabilities under these statutes rest on two bases. One is the provision of Section 29 (b) of the Exchange Act—substantially repeated in the Holding Company, Investment Company and Investment Advisers Acts—to the effect that every contract made in violation of the statute or any rule thereunder, as well as every contract whose performance will involve such a violation, shall be 'void' as regards the rights of (1) any violator and (2) any person, not a party to the contract, who acquires any right thereunder with actual knowledge of the facts resulting in the violation. • • •
>
> "The other basis of the implied liabilities is the common-law tort doctrine of private action based on violation of a statute. • • • It is all a matter of 'legislative intention.'"

Many of these cases have relied upon the decision of this Court in **Texas & P. R. Co. v. Rigsby**, 241 U. S. 33, 40, 60 L. Ed. 874, 36 S. Ct. 482 (1916), wherein the "inference of a private right of action" for violation of a Federal statute was upheld on the application of the maxim,

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and *Fischman v. Raytheon Mfg. Co.*, 188 F. 2d 783 (2d Cir., 1951); the Third Circuit: *Slavin v. Germantown Fire Ins. Co.*, 174 F. 2d 799 (3rd Cir., 1949); the Seventh Circuit: *Juneau v. K & D Mining Co.*, 260 F. 2d 607 (7th Cir., 1958); the Ninth Circuit: *Pratt v. Robinson*, 203 F. 2d 627 (9th Cir., 1953), and *Errion v. Connell*, 236 F. 2d 447 (9th Cir., 1956); *Matheson v. Armbrust*, 284 F. 2d 670 (9th Cir., 1960), *cert. denied*, 365 U. S. 870, 5 L. Ed. 2d 860, 81 S. Ct. 904, and recently, by the Fifth Circuit, *Hooper v. Mountain States Securities Corp.*, 282 F. 2d 195 (5th Cir., 1960), *cert. denied*, 365 U. S. 814, 5 L. Ed. 2d 693, 81 S. Ct. 695; and, more recently (since the instant decision), by the Sixth Circuit, *Dann v. Studebaker-Packard Corporation*, 288 F. 2d 201 (6th Cir., 1961).

"Ubi jus ibi remedium". This was a suit by a railroad employee for injury resulting from a violation of the Safety Appliance Act. This Court said (241 U. S. 39):

> "A disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied . . ."

Private remedies have been implied even though the same statute provided for other private remedies.* In **A. C. Frost & Co. v. Coeur D'Alene Mines Corp.**, 312 U. S. 38, 43, 85 L. Ed. 500, 61 S. Ct. 414 (1941), this rule was stated as follows:

> "Courts have often added a sanction to those prescribed for an offense created by statute where the circumstances fairly indicated this would further the essential purpose of the enactment; * * *."

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* Likewise, cases construing other securities acts have implied a remedy for breach of duty or violation of the Act under a general jurisdictional section contained in those acts, even though the right of action was not specifically given for the section violated, and an express remedy was provided under other sections of the same statute. See, for example, *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E. D. Pa., 1946), referred to in *Hooper v. Mountain States Securities Corporation, supra*, 282 F. 2d 195 (5th Cir., 1960), *cert. denied*, 365 U. S. 814, 5 L. Ed. 2d 693, 81 S. Ct. 695, as a "trail-blazer". In *Kardon*, the court adopted the rule as announced in Section 286 of the Restatement of the Law of Torts, imposing liability upon one who violates a statute by invading the interest of another, if the intent of the enactment was to protect the interest of the other and the interest invaded was one which the enactment was intended to protect. The court ruled that plaintiff was entitled to recover under Section 78 (j) of the Securities Exchange Act (making the employment of deceptive devices in the purchase of stock unlawful), even though there was no express civil liability for such violation, and this was true in spite of the fact that other sections of the same act did provide civil remedies (e g, Section 78 (p) which prohibited short-swing profits by insiders).

The Corporate Right to Sue:

A corporation has a right of action to recover for breach of duty or violation of a particular section of one of the securities acts when the section involved was intended to protect the corporation.* In **Hooper v. Mountain States Securities Corp.**, supra, 282 F. 2d 195 (5th Cir., 1960), *cert. denied*, 365 U. S. 814, 5 L. Ed. 2d 693, 81 S. Ct. 695, suit was brought on behalf of a bankrupt corporation to recover against defendants, who were insiders, for fraud in the sale and issuance of the corporation's own stock. This stock was issued in exchange for spurious assets transferred to the corporation by one of the defendants in violation of Section 78 (j), Title 15, U. S. C., and Rule X-10B-5 of the Securities Exchange Act, making it unlawful for a purchaser to defraud a seller. The court reversed a dismissal of the complaint and held the corporation was a "person" and entitled to sue; that it was an "investor" entitled to protection under the Act.

That court, on page 201, summed up the remedial character of the Securities Exchange Act as follows:

> "In a substantive way it is even more sweeping. It greatly expands the protection frequently so hemmed in by the traditional concepts of common law misrepresentation and deceit, the requirement of privity, proof of specific damage, inadequacy of the right of rescission or right to recover up to par value of stock of a much greater market value. To these difficulties would have to be added the geographic

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* *Goldstein v. Groesbeck*, 142 F. 2d 422 (2d Cir., 1944); *Stella v. Kaiser*, 82 F. Supp. 301 (S. D. N. Y., 1948); *Slazin v. Germantown Fire Ins. Co.*, 174 F. 2d 799 (3d Cir., 1949); *Collings v. Busch Manufacturing Co.*, 19 F. R. D. 297 (S. D. N. Y., 1956); *Hooper v. Mountain States Securities Corporation*, 282 F. 2d 195 (5th Cir., 1960), *cert. denied*, 365 U. S. 814, 5 L. Ed. 2d 693, 81 S. Ct. 695.

obstacle of suit in a common forum against multi-state defendants scattered as far as the fraudulent device required."

There have been limitations placed upon recovery for violations of such statutes. Naturally, plaintiff must show that it is within the class of persons which the statute contemplated to protect, and some cases have held for that reason (under the facts there involved) that the corporation was not entitled to recover.** Of course, there must be a causal connection between the violation or breach and plaintiff's claim of damage.***

Suits Dealing With Private Claims Under the Investment Company Act:

The Investment Company Act is much more far-reaching than these above mentioned Securities Acts. They are, by and large, disclosure acts. But the Investment Company Act, as Petitioner claims, is a statute regulating the internal affairs of a particular type of business.

Congress, in passing the Investment Company Act, determined that the Securities Act of 1933 and the Securities Exchange Act of 1934 were inadequate to abate or eliminate abuses in investment companies. See Senate Report No. 1775, 76th Congress, 3rd Session, June 6, 1940, where this statement appears on page 11.

A mutual fund, like any public corporation, must comply with the Securities Act of 1933 in the sale of its stock to the public insofar as the registration of its stock and the

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** *Birnbaum v. Newport Steel Corp.*, 193 F. 2d 461 (2d Cir., 1952); *Howard v. Furst*, 238 F. 2d 700 (2d Cir., 1956), *cert. denied*, 353 U. S. 937, 1 L. Ed. 2d 759, 77 S. Ct. 814 (distinguished in *Hooper v. Mountain States Securities Corp.*, 282 F. 2d 195 (5th Cir., 1960), *supra*.

*** *Downing v. Howard*, 162 F. 2d 654 (3rd Cir., 1947).

issuance of prospectuses are concerned. But, the Investment Company Act goes far beyond this. It contains provisions regulating management and regulates the advisory and underwriting contracts of these funds which Congress felt were susceptible to exploitation by insiders.

There have been few cases dealing with the private right to sue for breach of duty created by, or violation of the Investment Company Act, but in all cases to date, except for the instant ruling in the Court of Appeals, it has been recognized that a fund is entitled to sue and none except the decision of the Court of Appeals have held directors are immune from liability under the Act.*

A recent pronouncement of the theory of a fund's remedy and the Federal Court's jurisdiction in such cases is **Taussig v. Wellington Fund, Inc.**, 187 F. Supp. 179, 217 (D. Del., 1960):

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* (1 *Schwartz v. Bozeman*, 156 F. Supp. 361 (S. D. N. Y. 1957, appeal dismissed sub nom *Schwartz v. Eaton*, 264 F. 2d 105 (2d Cir., 1959), directors held subject to suit; (2) the Breswick cases [*Breswick & Co. v. United States*, 134 F. Supp. 132, 138 (S. D. N. Y. 1955); *Breswick & Co. v. Briggs*, 135 F. Supp. 397 (S. D. N. Y., 1955), investment company's claim against directors for "noncompliance with the Investment Company Act" was confirmed (pp. 403, 404); *Breswick & Co. v. United States*, 138 F. Supp. 123, 131 (S. D. N. Y., 1955), reversed on other grounds; *Allegany Corp. v. Breswick & Co.*, 353 U. S. 151, 1 L. Ed. 2d 726, 77 S. Ct. 703 (1957)]; (3) *Cogan v. Johnston*, 162 F. Supp. 907 (S. D. N. Y., 1958), jurisdiction of the court upheld in derivative suit against officers and directors operating an unregistered investment company. On page 909, the court in *Cogan* said:

> "I conclude that jurisdiction is properly invoked under Section 44 of the Investment Company Act, which grants to the district court jurisdiction of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, the Act or the rules, regulations or orders thereunder."

(4) See also, *Taussig v. Wellington Fund, Inc.*, 187 F. Supp. 179 (D. Del., 1960), *infra*. (5) *Brozen v. Bullock*, 194 F. Supp. 207 (S. D. N. Y., 1961), *infra*; (6) *Lutz v. Boas*, 171 A. 2d 381 (Ch. Ct. Del., 1961), *infra*.

"Violation of a federal statute may accord a private litigant a remedy by implication notwithstanding the absence of specific statutory authority conferring upon the injured the right to redress statutory wrongs, for the common law will supply a remedy where the statute is silent. The intention to create civil liability is presumed unless a contrary legislative intent is to be inferred from the whole purview of the Act."

A. **Directors of a mutual fund have a duty, under Section 15 of the Act, to see that advisory contracts, under which they operate, are initially approved by stockholders. Thereafter they have a duty under such Section to supervise the approval and extension of such contracts, and the payment of monies to insider investment advisers. This duty is breached by operating a fund with an unapproved contract or approving or extending contracts after assignment and termination especially with an adviser who renders no service for its fee, and in paying out money under contracts illegal under Section 15 and void under 47 (b). A fund can recover its losses from directors breaching such duties.**

By enacting Section 15, Congress entered the field of regulating insider, investment advisory contracts. The enactment required that such contracts be initially approved by stockholders and be in writing; that it be limited to two years' duration and be annually approved by directors and that the contract contain certain provisions; that the contract specify the compensation to be paid the adviser; that it contain a termination clause upon assignment, and that the contract also contain a 60-day termination clause, exercisable by the directors. The section specifies that after two years from initial approval by the directors and stockholders, the contract may be extended by majority of the board and the **unaffiliated directors** or by the shareholders. It is unlawful to operate without such an approved contract.

Section 15 (a), in full text, provides:

"(a) After one year from the effective date of this subchapter and sections 72 (a) and 107 (f) of Title II it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and—

"(1) precisely describes all compensation to be paid thereunder;

"(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

"(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

"(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser."

Section 15 (c) provides:

"(c) In addition to the requirements of subsections (a) and (b) of this section it shall be unlawful for

any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, except a written agreement which was in effect prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company."

Section 47 (b) [80a-46 (b)] imposes a substantive sanction. It declares:

> "Every contract made in violation of any provision of this subchapter . . . and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this subchapter . . . shall be void . . ."

Such a statutory sanction was given remedial effect to support the claim of a public utility against its holding company and directors in an important case in the Second Circuit, **Goldstein v. Groesbeck**, 142 F. 2d 422 (2d Cir., 1944), cert. denied, 323 U. S. 737, 89 L. Ed. 591, 65 S. Ct. 36. The Court there held the directors of Electric Bond and Share liable for violation of duty in failing to register EBS as required by the Public Utility Holding Company Act. The suit was on behalf of the subsidiary corporation for amounts paid out under a contract with an affiliate (Ebasco) of said unregistered company (EBS). The contract was therefore (by that Act) unlawful and void. That Court, in ruling that the plaintiff stated a claim, said on pages 425 and 426:

"Section 25, U. S. C. A., § 79y [identical to Section 44 of the Investment Company Act], provides that 'any suit or action to enforce any liability or duty created by' the Act may be brought 'in the district wherein any act or transaction constituting the violation occurred' or 'in the district wherein the defendant is an inhabitant or transacts business.' The present action is surely to enforce a duty created by the Act, since but for the Act the payments under the service and construction contracts would be innocuous enough; and the words 'any liability or duty' are clearly broad enough to include any breaches of duty causing injury or loss to private persons."

. . . . . .

"Thus, the statutory declaration of the necessity for control of holding companies in § 1 (b) (2), 15 U. S. C. A., § 79a (b) (2), states, inter alia, that the national public interest is adversely affected 'when subsidiary public utility companies are subjected to excessive charges for services.' The three specific sanctions stated in the Act—injunction, § 18 (f), 15 U. S. C. A., § 79r (f); criminal punishment, § 29, 15 U. S. C. A., § 79z-3; and the negative relief of § 26 (b), declaring the contracts void—do not in terms place the defrauded operating company in statu quo; and § 26 is incomplete, if not ineffective, unless it is considered to authorize recovery by the operating companies."

The above cited section of the Public Utility Holding Company Act [§ 26 (b)], making illegal contracts void, is identical to Section 47 (b) of the Investment Company Act of 1940.

The Investment Company Act, like the Public Utility Holding Company Act, is much more than a disclosure act. It is a Federal Corporation Code, superimposed on state law, regulating the internal affairs of every corporation engaged in the mutual fund business.

There has been a recent case decided by Judge Herlands, of the Southern District of New York, since the ruling of the Court of Appeals, which has eloquently announced the Fund's position, that directors of a mutual fund have duties under Section 15 of the Act regarding the extension of, and payment of monies under insider advisory contracts. **Brown v. Bullock**, 194 F. Supp. 207 (S. D. N. Y., 1961). (The Second Circuit has permitted an interlocutory appeal, which has been argued and is pending.)

This case was a stockholder's suit on behalf of the Bullock fund (called Dividend Shares, Inc.) against the officers, directors and investment adviser to repay excessive advisory fees to the fund. There, as in this case, the complaint alleged that the directors were under the dominion of the insiders and blindly approved the contract with the adviser controlled by such insiders. However, in **Bullock** there were no allegations, as here, that there were **no** services being performed under the advisory contracts, but only that the amounts paid were excessive. Although in **Bullock** the directors' authority to approve these contracts was questioned, there was no claim, as here, that the advisory contracts were illegal or void. Nor was there a claim, there, of a deviation from stated investment policy by the directors there sued.

The District Court in **Bullock**, in a comprehensive opinion, ruled that the complaint stated a claim and that the court had jurisdiction under the Act. The court, on page 235, held that the directors of a fund have duties under Section 15 of the Act:

> "The directors are thus charged by the Act with critically important powers and duties of a specific nature. Each year they must pass upon the extension of the investment advisory contract, unless they refer the decision to the stockholders; they (the directors)

have the authority to terminate the contract 'at any time' on sixty days' notice; and, when the contract is made or is to be renewed, there must be a majority of the disinterested directors.

"**The grant of these defined powers, as specified by the Act, carries with it the imposition of corresponding duties. The power to extend the investment advisory contract necessarily carries with it the duty to determine whether or not the extension is desirable and in the best interest of the company. The power to terminate the investment advisory contract necessarily carries with it the duty to keep alert for reasons which might make termination necessary or desirable**; and, in the presence of such reasons, to exercise the right of termination. The objectives of the Act would be nullified if the directors were free to extend mechanically the contract without honestly exercising their best judgment. The objectives of the Act would be equally frustrated if the directors were free to close their eyes to any developments making the termination of the contract advisable.

"By giving the directors the right to extend and to terminate the contract, the Act necessarily also imposes upon the directors the fiduciary duty to use these powers intelligently, diligently and solely for the interests of the company and its stockholders. These specific fiduciary duties are created by the Act. Their violation subjects the directors to liability, which can be enforced in the federal courts under section 44 of the Act." (Emphasis supplied.)

What duties did respondents have regarding these two contracts? (1) the contract with Slayton Associates which was initially approved and then extended throughout the period; (2) the contract with Jaquith and the brokers which was never approved. First, the Slayton Associates contract.

1. Section 15 (a) provides that an advisory contract is in effect "only so long as such continuance is specifically approved at least annually by the board of directors." Section 15 (c) makes it ultra vires and illegal for a fund which has a board of directors to "renew" or "perform" any advisory contract without approval of a majority of the unaffiliated ("outside") directors. These sections impose duties (as to specific contracts of the corporation) of vigilance and due care on directors in making such extensions, and certainly the directors cannot knowingly extend and pay money to an adviser (i. e. "perform") when the adviser's contract has been unlawfully assigned and the insider performs no services for the payments.

Section 15 (a) imposes a specific statutory duty on all directors, the managers of the Fund, with respect to extending advisory contracts initially approved by the stockholders. The Act authorizes the stockholders to extend these contracts, but if the directors take on this statutory function, as they are empowered to do under Section 15 (c), they must exercise due care. This approval by them is the hallmark of legality. Directors do not discharge their function by approving an advisory contract which gives insiders a license to abstract monies from the Fund.

The directors have the power to terminate such a contract. They have a correlative duty of vigilance to see to it that the adviser being paid is performing. They have a duty not to knowingly pay an adviser who has abdicated to another, thereby, by the adviser's own act, automatically terminating the contract [15 (a) (4)], and making it and the relationship void under 47 (b).

Not only do the provisions of the Act relied upon impose duties upon the entire board of directors, but Subsection 15 (c) imposes a specific power and duty on "un-

affiliated" directors regarding the performance and renewal of advisory contracts. That section provides that it is "unlawful" for advisory contracts to be renewed or performed "unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, . . .". The subsequent phrase, also conferring such power on the shareholders is not in derogation of the power of the unaffiliated directors.

This section manifestly places supervisory duties upon those members of the board who are not affiliated with the adviser, to prevent the latter from making its own self-dealing, inside contracts. The statute contemplates that the unaffiliated directors are to be the "watch-dogs" for the shareholders in approving or disapproving (not rubber stamping) advisory contracts. These directors certainly have the duty not to extend knowingly, renew or pay out monies (perform) under a contract where the adviser-contractor is not doing the work and the contract is terminated by assignment under Section 15 (a) (4), and the relationship is therefore void under the Act, 47 (b).

Next, the unapproved Jaquith contract.

2. **Section 15 (a) makes it illegal under any circumstances to initially employ an adviser unless such contract is initially approved by shareholders. The directors have a duty under 15 (a) and 15 (c), to require the employment of the actual adviser to be submitted to stockholders for their approval or disapproval. They have a corresponding duty not to perform, pay out money, under such an unapproved contract.**

The Jaquith contract was made by the inside directors through their alter-ego, Slayton Associates. It was per-

formed for five and one-half years without any approval of shareholders. Under the definitions of the Act, Section 2 (a) (19), Jaquith and the defendant brokers were in fact the Fund's adviser. The directors have a duty to require submission of such an advisory contract to the shareholders.

Section 15 thus added to every investment company charter a new *ultra vires* clause concerning the requisite approval of advisory contracts.

Congress by this Act recognized and recited that there then existed a conflict of interest in the inside relationship of investment advisers to these companies—and that advisers were frequently represented on the Board of Directors. Congress did not outlaw this conflict of interest; but neither did Congress leave the investor to proof that such illegal contracts (voidable at common law) actually damaged the Fund. Congress—recognizing such self-interested dealing—provided that the advisory contracts should be disclosed and approved by shareholders, subject always to short-term renewal, or cancellation by the Board itself—with a particular responsibility, upon the disinterested directors, for renewal. The penalty for failure to follow the statutory procedure made the contract illegal and void without more.

How can it be said that liability, based upon violation of the statutory command, does not fall upon the Board of Directors. The function of investment advice was at the very center of the management function: The management of the Fund is the function of the Board and the adviser is **their** adviser. They knew the command of the statute, requiring approval of stockholders for any adviser which they accepted. Can the Board be heard to say that they did not inquire whether their own adviser was legally qualified—despite routine and necessary contacts? It should rather be held that a cause of action is

stated by the mere averment that an investment adviser was employed, and that his employment was not authorized in the manner required by the statute.

But these complaints state that these directors actually knew the relationship of the Slaytons and Jaquith and Model to the Fund (R. 10). These complaints state further that in the ordinary discharge of their duties they knew or should have known of these violations of law (R. 3). If directors knowingly permit violations of these prohibitions or exceed their powers, as defined by this statute, they are liable for losses or damages resulting from such unlawful and void advisory contracts.

If directors know that advisory contracts of this kind must be approved by shareholders and that the shareholders have not approved such contracts, they are exceeding their statutory powers and thereby violating the duty imposed upon them by statute (not by common law) when they knowingly operate with such an adviser. The unapproved advisory contract was not only illegal, but void under the Act [Section 47 (b)]; the directors have a statutory duty not to pay out money under such a contract, knowing it is not approved and, hence, illegal under the Act.

Unquestionably, directors have specific duties under Section 15 in submitting for approval, extending and performing investment advisory contracts. Yet the Court of Appeals, in its opinion, fails to discuss Section 15. The duties, and respondents' breaches thereof, appear even more apparent in this extreme case, which involves many more abuses and more obvious loss than the single claim of excessiveness which was held a sufficient breach of duty in **Bullock**.

But, directors also have duties regarding a fund's investment policy, the second important aspect of this case which the Court of Appeals failed to discuss.

B. The directors of a mutual fund have a duty to require adherence by the fund to its fundamental investment policy, stated pursuant to Section 8 (b) (2). Directors who are charged with the fund's management are liable for losses when they participate with insiders in causing a deviation from such policy contrary to Section 13 (a) (3).

The complaints cite another substantive regulation of the management of investment companies—manifestly aimed at management by the board of directors—requiring declaration by the management of investment policies which were deemed fundamental [Section 8 (b) (2)], and making it illegal to deviate from such policy without approval of shareholders [Section 13 (a) (3)].

Section 8 (b) (2) provides:

> "(b) Every registered investment company shall file with the Commission, within such reasonable time after registration as the Commission shall fix by rules and regulations, an original and such copies of a registration statement, in such form and containing such of the following information and documents as the Commission shall by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors:
>
> "(2) a recital of the policy of the registrant in respect of matters, not enumerated in paragraph (1) of this subsection, which the registrant deems matters of fundamental policy and elects to treat as such;"

Section 13 (a) (3) provides:

> "(a) No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—
>
> . . .
>
> "(3) deviate from its policy in respect of concentration of investments in any particular industry or

group of industries as recited in its registration statement, or deviate from any fundamental policy recited in its registration statement pursuant to section 80a-8 (b) (2) of this title;"

These sections which require adherence to stated policy are also new, substantive Federal regulations of such corporations. Fundamental investment policy is the function of the Board of Directors. The directors have a statutory duty to prevent, or certainly not to cause or participate in causing, a deviation from stated investment policy. The prohibition of the statute against fundamental change in the nature of the investment policy is not a mere common law prohibition. Violation was a breach of a statutory duty.

Since filing this petition for certiorari, a relevant decision was handed down by Chancellor Seitz in the Chancery Court of New Castle County, Delaware, **Lutz v. Boas**, 171 A. 2d 381 (Ch. Ct., Del., 1961). This decision was rendered in a companion case involving the very same facts as here alleged. That case was originally a derivative suit in which Managed Funds joined as plaintiff, after respondents challenged jurisdiction of the United States District Court in Missouri.

Illustrating the importance of Federal jurisdiction, none of the directors were found in Delaware and the only two who were there joined were served by sequestration of their stock in the Fund.*

The Delaware Court held in this case, on the merits, that Jaquith and the brokers, defendants in the instant case, were illegal investment advisers under the Investment Company Act, as here alleged, and that there was, among

* Only respondent Rice appeared following sequestration of his stock. Respondent Relstock's stock was also sequestered, but he did not appear.

other wrongs, a violation of the Federal Act because of a deviation from the Fund's policy of capital growth by all the defendants and by the directors who managed the Fund. This deviation caused the Fund damage by "losses incurred because of violation of Funds' investment policy." (171 A. 2d 395.) The Court goes on to conclude that the two directors there before the Court were liable for this deviation from stated policy:

> "I am satisfied that these directors are liable because I think it is clear that had they discharged their responsibilities as to general supervision they would have discovered these violations of the Funds' investment policy" (171 A. 2d 396).

This deviation from stated policy is made illegal by the Investment Company Act, Section 13, not the common law.

A deviation is *per se* or presumptively improper and all parties participating,—especially the managing board, particularly if they do so knowingly, should be held liable to the fund for its losses. Without discussing the respondents' duty and manifest responsibility for the deviation from policy, the Court of Appeals referred to *per se* liability (R. 60). The Court mentions this concept in the same breath with its conclusion that the complaints asserted insurers' liability (R. 71). Apparently the Court conceived that petitioner was claiming that, because the corporation violated the statute, the directors were *ipso facto* "per se" liable, whether or not the directors participated in the violation by virtue of their office or status, as if there were no averments of knowing violation: The Court seemed to interpret the averments of the complaints as an assertion of vicarious liability on the managers as though the duty belonged to someone else to manage the Company.

This is not now, nor has it ever been, petitioner's theory. We did say that respondents were liable if their conduct directly or indirectly caused the Fund to violate the Act. We have always claimed these directors' liability rested on breaches of their **own** duty, not someone else's. The fact that others were more active joint tortfeasors, who directly profited, does not exculpate these respondents for their breaches of duty which concurred in causing loss to the Fund.

The Sections of the Act prohibiting a deviation from policy create a statutory limitation on management. We submit that there must be a substantial departure to be a deviation and there must be losses resulting therefrom for the conduct to be actionable. **Lutz v. Boas**, supra, shows how such substantial losses may be proved in this very case, from such illegal deviation, namely, sales contrary to the "capital growth" policy, and immediate repurchase at higher prices -a plain loss to the Fund. If advisers, officers or directors, whomever they be, knowingly cause, or participate in the deviation and cause this loss, they breach a statutory duty over which the Federal court will take jurisdiction.

C. Directors who knowingly cause their corporation to violate the Act breach duties created thereby. Furthermore, directors who aid or abet a fund in violating the Act are themselves in violation of the statute.

The Court of Appeals noted (R. 68) that, "there is a sense in which it can be said, as appellees (petitioner here) have argued, that directors control the various corporate actions of management on policy", but concluded that the provision defining "control" somehow excluded directors' liability in this case. The Court was concerned with liability of directors by mere virtue of their holding office and ignored completely the allegations in the complaints

that the defendants (including respondent directors) knowingly breached statutory duties, and participated in, and aided and abetted in causing the violations of the Act (R. 6).

Not only does the Act impose specific duties on directors, but they have recognized duties of management of a fund. Certainly it is a breach of these duties to participate in causing the fund to violate the Act. Directors cannot excuse their conduct in knowingly causing a fund to violate the Act by saying that the corporation violated the Act and that they are not responsible or that they are not themselves in violation.

In **Thompson v. Greeley**, 107 Mo. 577, 17 S. W. 962 (1891), the directors of a savings bank made excessive loans in violation of the state banking statute. The statute there imposed no penalty or liability on either the "corporation or its directors for the violation of its provisions" (p. 591), and the prohibition in the statute was directed against the corporation only—the statute providing, "no corporation . . . shall loan its money" (p. 591), in excess of certain amounts designated in the statute. The court noted that there was no allegation of bad faith or negligence on the part of the directors—the action was for the violation of statutory duty. The court adopted the view that the directors causing the corporation to violate the statute breached their duties to the corporation and were liable for resulting losses:

> "But every violation of law is a breach of duty . . . Whether that duty required good faith and honesty in the administration of the affairs and business of the corporation as is imposed at common law, or whether it was a duty enjoined or an act prohibited by statute could make no difference so far as doing or omitting them might affect their liability . . . The statute fixed the authority of the directors, in

> respect to the amount in which any person, firm or corporation might become indebted to the bank, and if they wilfully and knowingly permitted the Anchor Milling Company to become indebted to it to a greater amount than was authorized by the statute, and loss to the bank resulted therefrom, they are, and in right should be, liable for such losses . . . The wilful violation of the statute, and consequent loss therefrom furnish sufficient proof of liability" (p. 592).

Also, in **Broderick v. Marcus**, 152 Misc. 413, 272 N. Y. Supp. 455 (Sup. Ct., 1934), an action was brought on behalf of a bank against its former directors for losses arising out of unsecured loans made to an affiliate, which was trading in the bank's shares, in violation of banking laws. As to the basis of the liability of the directors, the court said, 272 N. Y. Supp. 458:

> "The action against the directors involves their accountability from a double aspect: First, that the loans were improvident in that they were made upon no security to corporations without substantial assets; and, second, and more important, that in making the loans which have resulted in the losses referred to the directors violated the banking laws, and the consequences of such violation are the losses of millions of dollars to the bank and its creditors."

The violation of the banking laws referred to placed certain prohibitions on **the bank.** There was no direct statutory prohibition placed on the directors, but the prohibitions contained in the law were mandates to directors. Relying on the case of **People v. Knapp**, 206 N. Y. 373, 99 N. E. 841 (1912), the court held, 272 N. Y. Supp. 460:

> "Consequently the violations of Section 108 in which the directors knowingly participate makes

them severally accountable for damages which such participation occasions."

The **Knapp** case was a criminal action brought against a director of a corporation for violation of the banking laws. The penal statute provided that, 99 N. E. 843:

> "Every director . . . who: . . . (2) wilfully does any act as such director which is expressly forbidden by law, or willfully omits to perform any duty imposed upon him as such director by law, is guilty of a misdemeanor."

It is quite evident that before there could be a conviction under this statute, there had to be an act which the director was "expressly forbidden" to do by law, or which constituted a violation of a "duty" imposed by law,—one of the same issues presented in this proceeding.

The Court of Appeals of New York held counts of an indictment sufficient under this penal section even though the banking section allegedly violated placed restrictions only on **banks** as to the manner of lending money, and there was no **direct statutory prohibition against the directors.**

> "As to the remaining counts the defendant insists that the command that a corporation shall not do a certain act is not a command that the directors shall not do the act. A corporation, however, is a mere conception of the legislative mind. It exists only on paper through the command of the Legislature that its mental conception shall be clothed with power. All its power resides in the directors. Inanimate and incapable of thought, action, or neglect, it cannot hear or obey the voice of the Legislature except through its directors. It can neither act nor omit to act except through them. **Hence a command addressed to a corporation would be idle and vain**

unless the Legislature in directing the corporate body, acting wholly by its directors, to do a thing required or not to do a thing prohibited, meant that the directors should not make or cause the corporation to do what was forbidden, or omit to do what was directed. We think, as the Appellate Division held, that when the corporation itself is forbidden to do an act, the prohibition extends to the board of directors and to each director, separately and individually" (99 N. E. 844).

In addition an officer or director who aids and abets a corporation in violating the law is a principal and is likewise a statute violator. Section 2 (a) of Title 18 U. S. C. provides:

> "Whoever commits an offense against the United States, or aids, abets, counsels, commands, induces or procures its commission, is a principal."

It is the rule that one who causes a corporation to commit a crime may likewise be adjudged in violation. The court in **Wood v. United States**, 204 Fed. 55, 58 (4th Cir., 1913), stated the rule as follows:

> "A corporation can only act through human agencies. If the persons who actually direct and commit the frauds upon the government are not distillers or persons having superintendence of a still, as charged in the counts of the indictment under consideration, no one can ever be in those cases in which the distillery belongs to and is operated by a corporation. Speaking with precise technical accuracy, it may be said that what happened was that the corporation committed these offenses and that the defendants and each of them knowingly, willfully, and actively aided, abetted, and procured their commission."

In **Carolene Products Co. v. United States,** 140 F. 2d 61 (4th Cir., 1944), the corporation and certain officers were convicted for violation of the Filled Milk Act, 21 U. S. C., Section 61, et seq. In this case, the Government admitted that there was no evidence in the record to show that the individual defendants personally made, or even had any personal knowledge of, the eight shipments set out in the indictment. Judge Dobie in affirming the conviction held these officers who were charged with management were responsible for the unlawful act of the corporation.

This Court, in **United States v. Dotterweich,** 320 U. S. 277, 88 L. Ed. 48, 64 S. Ct. 134 (1943), upheld a conviction of corporate officers for violation of the Food and Drug Act (Section 301 et seq., Title 21, U. S. C.) by their corporation, which had been acquitted by the trial court.

This court reversed a decision by the Court of Appeals and reinstated the conviction of the officers, the acquittal of the corporation illustrating the reality that the "only way in which a corporation can act is through individuals who act on its behalf" (320 U. S. 281). Mr. Justice Frankfurter concluded that it was the Congressional intent to put responsibility on corporate managers, and said, p. 283:

> "It is not credible that Congress should by implication have exonerated what is probably a preponderant number of persons involved in acts of disobedience—for the number of non-corporate proprietors is relatively small. Congress, of course, could reverse the process and hold only the corporation and allow its agents to escape. In very exceptional circumstances it may have required this result. See Sherman v. United States, 282 U. S. 25, 75 L. ed. 143, 51 S. Ct. 41. But the history of the present Act, its purposes, its terms, and extended practical construction lead away

from such a result once 'we free our minds from the notion that criminal statutes must be construed by some artificial and conventional rule.' United States v. Union Supply Co., 215 U. S. 50, 55, 54 L. ed. 87, 88, 30 S. Ct. 15."

The Court went on to say, on p. 284:

"The Circuit Court of Appeals was evidently tempted to make such a devitalizing use of the guaranty provision (exonerating a purchaser receiving same) through fear that an enforcement of § 301 (a) as written might operate too harshly by sweeping within its condemnation any person however remotely entangled in the proscribed shipment. But that is not the way to read legislation. Literalism and evisceration are equally to be avoided. **To speak with technical accuracy, under § 301 a corporation may commit an offense and all persons who aid and abet its commission are equally guilty. Whether an accused shares responsibility in the business process resulting in unlawful distribution depends on the evidence produced at the trial and its submission—assuming the evidence warrants it—to the jury under appropriate guidance.**"

The application of the above cited aider and abettor statute (Section 2 of Title 18, U. S. C.), is not limited to criminal proceedings, but has been applied to civil cases under the Securities Acts, see Louis Loss, Securities Regulations, p. 846, Fn. 119.

On the aspect of "causing" a violation, we cited below **R. H. Johnson & Co. v. S. E. C.**, 198 F. 2d 690 (2d Cir., 1952). This case, although it does not deal with directors' liability, does hold persons who fail to supervise or carry out their duty are responsible for "causing" violation of the Securities Acts.

The Investment Company Act does have a procuring violation section, Section 48 (a), 80a-47 (a) of Title 15, U. S. C., making it unlawful for any person to cause, directly or indirectly, a violation. A like section under the Public Utility Holding Company Act (Section 79z-1a of Title 15, U. S. C.) was cited in **Goldstein v. Groesbeck, supra,** 142 F. 2d 422, 426 (2d Cir., 1944), as a basis for sustaining the complaint.

The Investment Company Act of 1940 imposes duties on directors and they are liable to a fund for resulting damage from their breach of such duty or their participation in violation of the Act.

D. **The entire Investment Company Act, its purposes and legislative history, indicate a clear legislative intent to impose duties on directors to protect a fund and its investors from conflicts of interest in management.**

The purposes and declaration of policy are found in Section 1 (b) of the Act, wherein it is provided:

> "the interest of investors is adversely affected—
>
> "(1) when investors purchase, . . . without adequate, accurate, and explicit information, fairly presented, concerning the . . . policies . . . of such companies and their management;
>
> "(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, . . . in the interest of underwriters, brokers, or dealers, . . . rather than in the interest of all class of such companies' security holders;
>
> . . .
>
> "(4) . . . when investment companies are managed by irresponsible persons;
>
> . . .

"(6) when investment companies . . . change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;"

The Court of Appeals in its efforts to determine legislative intent does not mention these declared purposes of the Act. We submit its decision has frustrated the legislative purpose. Other courts have implemented such statutory purposes as an additional reason for implying a remedy, **Goldstein v. Groesbeck, supra**, 142 F. 2d 422, 426 (2d Cir., 1944).

In **Aldred Inv. Trust v. S. E. C.**, 151 F. 2d 254, 260 (1st Cir., 1945), cert. denied, 326 U. S. 795, 90 L. Ed. 483, 66 S. Ct. 486, the court said:

"§ 1 (b) of the Act, 15 U. S. C. A., § 80a-1 (b), in effect codifies the fiduciary obligations placed upon officers and directors of investment companies."

These statutory fiduciary duties have been recognized. **Breswick & Co. v. United States**, *supra*, 134 F. Supp. 132 (S. D. N. Y., 1955), 138 F. Supp. 123 (S. D. N. Y., 1955), reversed on other grounds: **Alleghany Corp. v. Breswick & Co.**, 353 U. S. 151, 1 L. Ed. 2d 726, 77 S. Ct. 763 (1957):

"One of the purposes of the Investment Company Act is thus to protect investors in investment companies against the managing of those companies in the interests of persons other than the investors." (134 F. Supp. at 138.)

It has also been significantly noted that in construing this Act, Congress gave a directive of broad construction to the courts. Again, in **Brown v. Bullock**, *supra*, 194 F. Supp. 207 (S. D. N. Y., 1961), page 218, the court said:

"Congress built into **the statute a canon of construction.** This is set forth in the concluding sentence of section 1, as follows:

> "'It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.'

"This is more than a mere exordium. It is a directive to the courts.

"Section 1, entitled 'Findings and Declaration of Policy,' finds 'that the investment companies are affected with a national public interest' in the light of five enumerated factors, recited in subsection '(a).' The fifth of such factors, referring to the inadequacy of 'State regulation,' reads as follows (emphasis supplied):

> "'(5) the activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, **make difficult, if not impossible, effective State regulation of such companies in the interest of investors.**'" (Emphasis added.)

This was a reality which made it necessary to give suitors a Federal forum with long-arm service of process.

The Act specifically entered the field of director responsibility. Section 9 relates to the eligibility of directors. Section 10 limits directors, affiliated with an adviser, to 60% of the Board. At the hearings in the Congress when this bill was passed, a representative of the

Securities and Exchange Commission stated that the requirement of 40% independent directors "is one of the most salutary provisions of this bill." (Hearings before the Sub-committee of the House Committee on Interstate and Foreign Commerce, H. R. 10065, 75th Congress, 3rd Sess., at 109 [1940].)

Section 10 ties in directly with Section 15 and is the compromise referred to by the Court of Appeals (R. 60), in drafting and enacting said law. There were those who wanted to outlaw self-dealing contracts entirely. The Congress compromised for the sake of reality and the result was Section 15 and, in particular, Section 15 (c), requiring insider contracts to be renewed by vote of the unaffiliated directors. Jaretzki, "The Investment Company Act of 1940", supra, 26 W. U. L. Q. 303 (1941). Congress did not intend that the duties imposed on directors under Section 15 would be discharged by a rubber stamp to the benefit of insiders.

Other sections of the Act show the legislative intent to impose statutory duties upon directors: Section 17 (h) prohibits exculpatory provisions in articles of incorporation, etc., as to the liability of directors. Even where directors do not violate specific statutory duties, as in this case, Section 36 prohibits their gross misconduct or gross abuse of trust. Section 33 (a) requires the fund to report to the S. E. C. settlement of suits against directors for breach of their "official duty."

In the hearings on the bill, the abuses referred to in the purposes sections were detailed.

In the Report of the Hearings of the bill before the Subcommittee on Interstate and Foreign Commerce (75th Congress, 3rd Session, on H. R. 10065, June 13 and 14,

1940), Mr. Schenker summarized the purposes of the bill regarding investment policy:

> "A major problem in the case of management companies is created by the absence of any legal requirement for adherence to any announced investment policies or purposes. Such policies have often been radically changed without the knowledge or prior consent of stockholders. Similarly, after investors have invested in companies on their faith in the reputations and standing of the existing managements, control of the public's funds has frequently been transferred without the prior knowledge or consent of stockholders to other persons who were subsequently guilty of gross mismanagement."

The special significance of Section 44: The jurisdictional section itself is far-reaching in its purpose. It provides concurrent jurisdiction in the state as well as Federal court for actions at law or in equity for violation or breach of duty created by the Act. The Commission can sue only in the Federal court (Section 36) so that Congress must have intended a private remedy in either the Federal or state courts with the procedural advantages afforded a suitor by the long-arm service of process provision set forth in Section 44, if plaintiff selected the Federal forum.

In **Remar v. Clayton Securities Corp.**, 81 F. Supp. 1014 (D. Mass., 1949), Judge Wyzanski in construing Section 27 of the Securities Exchange Act, likewise giving the Federal court jurisdiction over "suits in equity and actions at law to enforce any liability or duty created by" that Act, said:

> "To be sure, the statute created the liability by implication, not by express words. But once the liability was created, its extent was to be measured by * * *

federal rather than a state common law (citations omitted). Suits to enforce a liability having such federal ancestry should be granted credentials of legitimacy in connection with this jurisdictional section of the statute."

There are duties imposed on directors under the Act and a fund can recover for its damage caused by a breach of said duties or violation of the Act.

II.

The Complaints Allege Breaches of These Duties, and Violations of the Act by Respondents to the Damage of the Fund.

The Complaints State Claims Under the Federal Statute. On a motion such as respondents', attacking jurisdiction, the rule is that the court should decide the case on the issue of whether plaintiff states a claim based upon the Constitution or Federal statute sued on, and such a complaint is sufficient unless the Federal question is "wholly unsubstantial or frivolous." **Bell v. Hood,** 327 U. S. 678, 90 L. Ed. 939, 66 S. Ct. 773 (1945). In reversing a dismissal for want of jurisdiction, this Court at 327 U. S. 681 said:

"Whether or not the complaint as drafted states a common law action in trespass made actionable by state law, it is clear from the way it was drawn that petitioners (plaintiffs) seek recovery squarely on the grounds that respondents violated the Fourth and Fifth Amendments. * * * It cannot be doubted therefore that it was the pleaders' purpose to make violation of these constitutional provisions the basis of this suit. Before deciding that there is no jurisdiction, the

district court must look to the way the complaint is drawn to see if it is drawn so as to claim a right to recover under the Constitution and laws of the United States. For to that extent, 'the party who brings a suit is master to decide what law he will rely upon and . . . does determine whether he will bring a 'suit arising under' the . . . (Constitution or laws) of the United States by his declaration or bill.' "

Mr. Justice Black continued (pp. 681-682):

"(W)here the complaint, as here, is so drawn as to seek recovery directly under the Constitution or laws of the United States, the federal court, but for two possible exceptions later noted, must entertain the suit. * * *

"The previously carved out exceptions are that a suit may sometimes be dismissed for want of jurisdiction where the alleged claim under the Constitution or federal statutes clearly appears to be immaterial and made solely for the purpose of obtaining jurisdiction or where such a claim is wholly insubstantial and frivolous."

Without discussing the content of the complaints or the liberal rules afforded a pleader in resisting a motion such as respondents', the Court of Appeals has followed to the letter respondents' version of petitioner's complaints, that it is "insurers' liability". But, " 'the party who brings a suit is master to decide what law he will rely upon.' " **Bell v. Hood**, supra, 681, quoting from **The Fair v. Kohler Die & Specialty Co.**, 228 U. S. 22, 57 L. Ed. 16, 33 S. Ct. 410 (1913).

We have contended all along that it is not insurers' liability (liability without fault) which the Fund seeks to impose on respondents. These directors were en-

dowed with specific powers over, and obligated by the Act to control particular self-dealing arrangements. This was **their** duty. The complaints allege that the directors knowingly participated, aided and abetted the insiders to violate the Act (R. 6, 19). **They** breached **their** own duties created by the Act.

We have set out above the averments of the complaints as to the "Participation and Knowledge of the Respondents 'Outside' Directors" in violating the Act and the duties imposed upon them.

While advanced as a reason for the derivative suit, here is what the **Josephson** complaint alleged (R. 19):

> ". . . that the directors of MF have approved, acquiesced in, ratified, committed and are committing the very wrongful, willful and illegal acts complained of herein, and the said directors are serving with the approval of, domination and control of the Slaytons and are beholden and completely subservient to their wishes, direction and control . . ."

The Fund's own complaint (R. 6) had a stronger allegation applicable to all defendants, which certainly did not exclude respondents:

> ". . . that the defendants committed, or with actual or constructive knowledge, as hereinabove set forth, aided, abetted, acquiesced in or condoned, directly or indirectly, violations of the Investment Company Act of 1940, . . ." (there follows the allegations relating to the statutory violations).

This is not insurers' liability, and we are not required to label respondents as "conspirators" as the Court of Appeals seems to imply (R. 70).

The Court of Appeals (R. 71) refers to the directors' liability for negligence. Of course, an action under Federal statute cannot be denied merely because the same conduct may afford a basis for action at common law. In **Osborn v. Bank of the United States**, 22 U. S. (9 Wheat.) 738, 818, 6 L. Ed. 204, 223 (1824), Chief Justice Marshall stated:

> "The suit of the **Bank of the United States v. Osborn et al.**, is a case, and the question is, whether it arises under a law of the United States?
>
> "The appellants contend that it does not, because several questions may arise in it, which depend on the general principles of the law, not on any act of Congress.
>
> "If this were sufficient to withdraw a case from the jurisdiction of the federal courts, almost every case, although involving the construction of a law, would be withdrawn; and a clause in the constitution, relating to a subject of vital importance to the government, and expressed in the most comprehensive terms, would be construed to mean almost nothing."

In fact, as above stated, a state chancellor has recently held two out of seven of the appellant directors to be liable in a companion case. **Lutz v. Boas**, 171 A. 2d 381 (Ch. Ct. Del., 1961). The ruling is relevant, because the decision rests upon the Federal Act, as well as upon general equitable principles.

In **Matheson v. Armbrust**, supra, 284 F. 2d 670 (9th Cir., 1960), the court held that the Securities Exchange Act gave the plaintiff an additional, Federal action. On pages 673, 674, the court said:

> "Actions brought to enforce any liability or duty created by section 10 (b) and rule X-10B-5 are therefore additional to state and any other federal actions.

Appellee, as plaintiff, may have had a choice between suing in state or federal court to recover damages for the fraud which appellant perpetrated. If so, the long-established principle is applicable, that 'the party who brings a suit is master to decide what law he will rely upon.' The Fair v. Kohler Die & Specialty Co., 228 U. S. 22, 25, 33 S. Ct. 410, 411, 57 L. Ed. 716.

"We therefore hold that the fact that appellee may have had an adequate civil remedy in the courts of Oregon did not deprive the district court of jurisdiction over the subject matter of this cause of action."

Rule 8 (a). Petitioner need only state a claim under Rule 8 (a) of the Federal Rules of Civil Procedure. On a motion to dismiss, the complaint "should be construed in the light most favorable to plaintiff", and such motion should be overruled "if it can reasonably be conceived that the plaintiff can make a case upon trial." **Jung v. K & D Mining Co.**, 260 F. 2d 607, 608 (7th Cir., 1958). In determining the sufficiency of a complaint, the accepted rule is "that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." **Conley v. Gibson**, 355 U. S. 41, 45, 46, 2 L. Ed. 2d 80, 78 S. Ct. 99 (1957).

The complaints alleged breaches of duty and violations of the Act by respondents (1) in approving and paying fees under the Slayton Associates contract, (2) in failing to have the Jaquith contract approved and making the payments under this illegal contract, and (3) in causing a deviation from stated policy.

1. These respondents knowingly approved contracts for advisory service each year for five years with a corporation which they knew was not performing the services for

which it was being paid, which had abdicated and illegally assigned is contract to the brokers (R. 5, 6, 15). Slayton Associates (the alter-ego of the inside directors) was employed by the Fund as the disclosed investment adviser "pursuant to successive written contracts . . ." from August 15, 1952, and continuing until the date of the commencement of this action (R. 15). The outside directors' affirmative acts in knowingly renewing the lucrative contracts with this shell corporation were positive breaches of their statutory duty. These affirmative acts permitted the payment of over $1,000,000 for services which were not rendered. But for such approval, required by Section 15 (c), there would have been no authority for such payment.

2. At the same time the respondents approved the above contracts, they knowingly permitted the Fund to operate with a broker-adviser whose contract was not disclosed or approved by stockholders, nor formally approved by themselves (R. 5, 6, 15, 16). They are alleged to have aided and abetted in the paying out of over $1,500,000 to the brokers under this second unlawful contract (*Ibid.*) This, then, is not mere negligence, but gross misconduct based upon respondents' own positive acts, and when the Fund under that management performed the contract they violated the prohibitions of the statute.

3. It is alleged that "the acts of the defendants have violated the primary and principal policy of 'capital growth'" (R. 16). The complaints specify that what was done was to churn the portfolio and to distribute the capital gains (dividends)—again the declaration of dividends, is a familiar function of the board of directors (R. 16). This was for the benefit of the "insiders" (R. 6). The policy followed by these directors resulted in gross "mismanagement" to the benefit of the insiders (R. 6).

Petitioner's complaint alleged breaches by respondents of the specific duties imposed by the Act and violations of the Act by respondents. The Trial Court, therefore, properly ruled that it had jurisdiction.

CONCLUSION: The issue here is neither non-feasance nor mere negligence. The issue here is liability of directors for irresponsible violation of law in the management of other people's money. Even when they do not directly profit by the unlawful operation, they must be held to have accepted the responsibility, powers and duties specifically imposed by the statute. As joint tort feasors, they must be held to respond in damages if they breach the very duties the law imposes upon them.

The Court of Appeals overlooked new standards of responsibility for both inside and distinterested directors, new duties in safeguarding and preventing self-dealing operations. The action against these directors is for damages. The Fund must, of course, prove damages proximately caused by respondents' breach of statutory duty and violations of the Act. For such damages petitioner should be entitled to recover from respondents. That is why Congress made illegal the corporate acts approved by these directors and created a new substantive law requiring specific corporate procedures in entering into, and supervising, self-dealing advisory contracts,—and imposing the penalties and sanctions of illegality and voidness, in case of any departure from these statutory procedures.

Some of the directors are located in various parts of the country and this is why the Congress included in Section 44 the long-arm provision for service of process. Such a case should be tried in a Federal tribunal with all joint tort-feasors before the Court. A body of Federal law should evolve construing this Act. **Textile Workers Union**

v. Lincoln Mills, 353 U. S. 448, 1 L. Ed. 2d 972, 77 S. Ct. 912 (1957).

For all the foregoing reasons, it is respectfully submitted that this Court reverse the decision of the Court of Appeals dismissing respondents from the action.

Respectfully submitted,

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APPENDIX.

(Statute and Rule Involved.)

Sections 1 (b) (1), (2), (4), and (6), Sections 80a-1 (b) (1), (2), (4) and (6) of Title 15, U. S. C.:

"(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z-4 of this title, and facts otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors are adversely affected—

"(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

"(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

"(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably

distributed, or when investment companies are managed by irresponsible persons;

"(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

"It is declared that the policy and purposes of this subchapter and sections 72 (a) and 107 (f) of Title 11, in accordance with which the provisions of this subchapter and sections 72 (a), and 107 (f) of Title 11 shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors. Aug. 22, 1940, c. 686, Title I, § 1, 54 Stat. 789."

Section 9 (a), Section 80a-9 (a) of Title 15, U. S. C.:

"(a) It shall be unlawful for any of the following persons to serve or act in the capacity of officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal underwriter for any registered open-end company, registered unit investment trust or registered face-amount certificate company:"
(here follows a list of persons disqualified from serving.)

Section 10 (a), Sections 80a-10 (a) of Title 15, U. S. C.:

"(a) After one year from the effective date of this subchapter and sections 72 (a) and 107 (f) of Title 11, no registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are investment advisers of, affiliated persons of an investment adviser

of, or officers or employees of, such registered company."

Sections 15 (a) and (c), Section 80a-15 (a) and (c) of Title 15, U. S. C.:

"(a) After one year from the effective date of this subchapter and sections 72 (a) and 107 (f) of Title 11 it shall be unlawful for any person to serve or act as investment advisor of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and —

"(1) precisely describes all compensation to be paid thereunder;

"(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

"(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

"(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser."

. . . . . .

"(e) In addition to the requirements of subsections (a) and (b) of this section it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, except a written agreement which was in effect prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company."

Section 8 (b) (2), Section 80a-8 (b) (2), of Title 15, U. S. C.:

"(b) Every registered investment company shall file with the Commission, within such reasonable time after registration as the Commission shall fix by rules and regulations, an original and such copies of a registration statement, in such form and containing such of the following information and documents as the Commission shall by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors:

. . .

"(2) a recital of the policy of the registrant in respect of matters, not enumerated in paragraph (1) of this subsection, which the registrant deems matters of fundamental policy and elects to treat as such;"

Section 13 (a) (3), Section 80a-13 (a) (3) of Title 15, U. S. C.:

"(a) No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

. . . . . .

"(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, or deviate from any fundamental policy recited in its registration statement pursuant to section 80a-8 (b) (2) of this title;"

Section 44, Section 80a-43 of Title 15, U. S. C.:

"The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this subchapter and sections 72 (a) and 107 (f) of Title 11, or the rules, regulations, or orders thereunder and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this subchapter and sections 72 (a) and 107 (f) of Title 11 or the rules, regulations, or orders thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. A criminal proceeding based upon a violation of section 80a-33 of this title, or upon a failure to file a report or other document required to be filed under this subchapter and sections 72 (a) and 107 (f) of Title 11, may be brought in the district wherein the defendant is an inhabitant or maintains his principal office or place of business. Any suit or action to enforce any liability or duty created by, or to enjoin any violation of, this subchapter and sections 72 (a) and 107 (f) of Title 11 or rules, regulations, or orders thereunder, may be brought in any such district

or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28 and section 7, as amended, of the Act entitled 'An Act to establish a court of appeals for the District of Columbia', approved February 9, 1893. No costs shall be assessed for or against the Commission in any proceeding under this subchapter and sections 72 (a) and 107 (f) of Title 11 brought by or against the Commission in any court. Aug. 22, 1940, c. 686, Title I, § 44, 54 Stat. 844."

Section 47 (b), Section 80a-46 (b) of Title 15, U. S. C.:

"(b) Every contract made in violation of any provision of this subchapter and sections 72 (a) and 107 (f) of Title 11 or of any rule, regulation, or order thereunder, and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this subchapter and sections 72 (a) and 107 (f) of Title 11, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, regulation, or order. Aug. 22, 1940, c. 686, Title I, § 47, 54 Stat. 845."

Rule 8 (a) of the Federal Rules of Civil Procedure:

"(a) **Claims for Relief.** A pleading which set forth a claim for relief, whether an original claim, counterclaim, cross-claim, or third-party claim, shall contain (1) a short and plain statement of the grounds upon which the court's jurisdiction depends, unless the court already has jurisdiction and the claim needs no new grounds of jurisdiction to support it, (2) a short and plain statement of the claim showing that the pleader is entitled to relief, and (3) a demand for judgment for the relief to which he deems himself entitled. Relief in the alternative or of several different types may be demanded."